

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

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REPORT OF INDEPENDENT AUDITORS

Board of Managers
The King's Daughters' Hospital and Health
Services and Affiliated Organization
Madison, Indiana

We have audited the accompanying consolidated balance sheets of The King's Daughters' Hospital and Health Services and Affiliated Organization (the "Hospital"), as of December 31, 2007 and 2006, and the related consolidated statements of activities, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Hospital, as of December 31, 2007 and 2006, and the results of its operations, changes in its net assets, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Blue & Co., LLC

April 3, 2008

**THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES
AND AFFILIATED ORGANIZATION**

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2007 AND 2006

ASSETS		
	<u>2007</u>	<u>2006</u>
Current assets		
Cash and cash equivalents	\$ 6,410,392	\$ 6,984,030
Patient accounts receivable, net of estimated uncollectibles of \$3,836,143 in 2007 and \$3,366,173 in 2006	15,416,379	15,663,875
Inventories	1,877,895	1,790,089
Prepaid expenses and other current assets	1,065,994	583,915
Other assets - current portion	180,512	159,657
Current portion of assets whose use is limited	<u>1,148,751</u>	<u>1,137,234</u>
Total current assets	26,099,923	26,318,800
Assets whose use is limited, net of amount required to meet current obligations	56,169,583	48,490,124
Property and equipment		
Land	5,409,870	4,339,410
Buildings and improvements	41,550,502	41,413,605
Fixtures and equipment	<u>34,204,924</u>	<u>28,906,737</u>
	81,165,296	74,659,752
Less accumulated depreciation	<u>43,600,547</u>	<u>40,146,107</u>
	37,564,749	34,513,645
Construction in progress	<u>1,761,042</u>	<u>754,184</u>
Property and equipment, net	39,325,791	35,267,829
Other assets, net of current portion	<u>4,070,362</u>	<u>4,493,014</u>
 Total assets	 <u>\$ 125,665,659</u>	 <u>\$ 114,569,767</u>

See accompanying notes to consolidated financial statements.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2007 AND 2006

LIABILITIES AND NET ASSETS

	2007	2006
Current liabilities		
Accounts payable	\$ 797,556	\$ 907,019
Accrued payroll and payroll withholdings	2,326,968	2,088,472
Accrued expenses	6,164,634	5,544,007
Estimated third-party payor settlements	893,274	950,000
Current portion of obligations under capital leases	249,299	2,473
Current portion of long-term debt	860,000	1,017,899
Total current liabilities	11,291,731	10,509,870
Long-term liabilities		
Obligations under capital leases, net of current portion	1,120,404	12,527
Long-term debt, net of current portion	12,955,000	14,455,000
Deferred compensation liabilities	1,295,863	1,124,301
Total long-term liabilities	15,371,267	15,591,828
 Total liabilities	 26,662,998	 26,101,698
Minority interest	35,280	49,055
Net assets		
Unrestricted	98,862,060	88,367,050
Temporarily restricted	95,321	41,964
Permanently restricted	10,000	10,000
Total net assets	98,967,381	88,419,014
 Total liabilities and net assets	 <u>\$ 125,665,659</u>	 <u>\$ 114,569,767</u>

See accompanying notes to consolidated financial statements.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

CONSOLIDATED STATEMENTS OF ACTIVITIES YEARS ENDED DECEMBER 31, 2007 AND 2006

	2007	2006
Changes in unrestricted net assets		
Operating revenues		
Net patient service revenue	\$ 111,448,399	\$ 105,549,043
Other revenue	704,113	729,357
Net assets released from restrictions	63,116	74,986
Total operating revenues	112,215,628	106,353,386
Operating expenses		
Salaries and wages	50,807,868	47,920,735
Employee benefits and payroll taxes	12,656,560	12,103,661
Professional medical fees	936,314	1,396,842
Medical supplies	4,524,278	4,391,645
Other supplies	857,610	873,776
Drugs	6,296,466	5,974,846
Food	535,025	535,327
Purchased services	4,306,511	3,680,992
Utilities	1,549,906	1,545,065
Insurance	1,451,860	1,460,691
Depreciation and amortization	4,955,538	4,650,517
Interest	865,615	893,355
Provision for bad debts	9,143,939	8,332,516
Other operating expenses	5,729,919	4,910,971
Total operating expenses	104,617,409	98,670,939
Income from operations	7,598,219	7,682,447
Nonoperating gains	2,650,882	1,993,013
Excess revenues and gains over expenses	10,249,101	9,675,460
Changes in net unrealized gains and losses on investments	304,958	1,529,908
Minority interest	13,775	(49,055)
Members' contributions	-0-	78,959
Members' withdrawals	(72,824)	(127,384)
Change in unrestricted net assets	10,495,010	11,107,888
Changes in temporarily restricted net assets		
Contributions	116,473	-0-
Net assets released from restrictions	(63,116)	(74,986)
Change in temporarily restricted net assets	53,357	(74,986)
Total change in net assets	<u>\$ 10,548,367</u>	<u>\$ 11,032,902</u>

See accompanying notes to consolidated financial statements.

**THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES
AND AFFILIATED ORGANIZATION**

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2007 AND 2006

	<u>2007</u>	<u>2006</u>
Unrestricted Net Assets		
Beginning of year	\$ 88,367,050	\$ 77,259,162
Change in unrestricted net assets	<u>10,495,010</u>	<u>11,107,888</u>
End of year	<u>\$ 98,862,060</u>	<u>\$ 88,367,050</u>
Temporarily Restricted Net Assets		
Beginning of year	\$ 41,964	\$ 116,950
Change in temporarily restricted net assets	<u>53,357</u>	<u>(74,986)</u>
End of year	<u>\$ 95,321</u>	<u>\$ 41,964</u>
Permanently Restricted Net Assets		
Beginning of year	\$ 10,000	\$ 10,000
Contributions	<u>-0-</u>	<u>-0-</u>
End of year	<u>\$ 10,000</u>	<u>\$ 10,000</u>

See accompanying notes to consolidated financial statements.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2007 AND 2006

	2007	2006
Cash flows from operating activities		
Total change in net assets	\$ 10,548,367	\$ 11,032,902
Adjustments to reconcile total change in net assets to net cash from operating activities		
Members' contributions	-0-	(78,959)
Members' withdrawals	72,824	127,384
Depreciation	4,368,007	4,065,777
Amortization	587,531	584,740
Provision for bad debts	9,143,939	8,332,516
Loss on disposal of capital assets	689,962	40,315
Change in net unrealized gains and losses on investments	(304,958)	(1,529,908)
Loss on impairment of capital assets	456,608	-0-
Minority interest	(13,775)	49,055
Changes in operating assets and liabilities		
Patient accounts receivable	(8,896,443)	(9,222,896)
Inventories	(87,806)	(116,371)
Prepaid expenses and other current assets	(482,079)	(58,181)
Accounts payable	(109,463)	(328,972)
Accrued payroll and payroll withholdings	238,496	150,293
Accrued expenses	620,627	807,454
Estimated third-party payor settlements	(56,726)	(150,000)
Net cash from operating activities	16,775,111	13,705,149
Cash flows from investing activities		
Purchases of property and equipment	(8,521,938)	(4,348,041)
Proceeds from sale of capital assets	353,568	29,600
Change in assets whose use is limited	(7,386,018)	(8,556,130)
Change in other assets	(185,734)	15,366
Change in deferred compensation liabilities	171,562	176,016
Net cash from investing activities	(15,568,560)	(12,683,189)
Cash flows from financing activities		
Principal payments on obligations under capital leases	(49,466)	-0-
Principal payments on long-term debt	(1,657,899)	(1,311,416)
Members' contributions	-0-	78,959
Members' withdrawals	(72,824)	(127,384)
Net cash from financing activities	(1,780,189)	(1,359,841)
Net change in cash and cash equivalents	(573,638)	(337,881)
Cash and cash equivalents, beginning of year	6,984,030	7,321,911
Cash and cash equivalents, end of year	\$ 6,410,392	\$ 6,984,030

See accompanying notes to consolidated financial statements.

**THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES
AND AFFILIATED ORGANIZATION**

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2007 AND 2006

	<u>2007</u>	<u>2006</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	<u>\$ 894,098</u>	<u>\$ 908,272</u>
Supplemental disclosure of noncash operating and investing activities		
Property and equipment acquired under accounts payable	<u>\$ -0-</u>	<u>\$ 116,035</u>
Supplemental disclosure of noncash investing and financing activities		
Property and equipment acquired under capital leases	<u>\$ 1,404,169</u>	<u>\$ 15,000</u>

See accompanying notes to consolidated financial statements.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

1. NATURE OF OPERATIONS

The King's Daughters' Hospital and Health Services ("KDHHS") is a not-for-profit, acute care hospital owned by the Bethany Circle of King's Daughters' of Madison, Indiana, Inc., located in Madison, Indiana. KDHHS is organized for the purpose of providing healthcare services to the residents of Jefferson County and the surrounding area. KDHHS's primary sources of support are from patient revenues. Patient revenues include funds received from Medicare, state agencies, insurance companies, and the patients themselves.

Madison Catheterization Services, LLC ("MCS"), is a limited liability company owned 51 percent by KDHHS. MCS performs catheterization services for the residents of Jefferson County, Indiana and surrounding areas. MCS's primary source of support is from patient revenues.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by KDHHS and MCS (collectively the "Hospital") in the preparation of the consolidated financial statements are summarized below:

Reporting Entity and Consolidation Policy

The accompanying consolidated financial statements include the accounts of KDHHS and MCS. Intercompany transactions and balances have been eliminated in consolidation.

Management's Estimates

Management uses estimates and assumptions in preparing the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, if any, and the reported revenues and expenses. Actual results could vary from the estimates that were used.

Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less except for those included in assets whose use is limited.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

Patient Accounts Receivable and Net Patient Service Revenue

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and fee schedule payments. Patient accounts receivable and net patient service revenue are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Allowances for Patient Uncollectible Accounts

The Hospital estimates an allowance for uncollectible patient accounts receivable based on an evaluation of the aging of the accounts, historical losses, current economic conditions, and other factors unique to their service area and the healthcare industry.

Inventories

Inventories consist of medical supplies, pharmaceuticals, and office supplies and are valued at the lower-of-cost or market, with cost being determined on the first-in, first-out (FIFO) method.

Assets Whose Use is Limited

Assets whose use is limited include assets set aside by the Hospital's Board of Managers for future capital improvements and other long-term uses, over which the Board retains control and may at its discretion subsequently use for other purposes; assets held by trustees under indenture agreements; temporarily restricted assets whose use by the Hospital has been limited by donors to a specific time period or purpose; permanently restricted net assets whose use by the Hospital has been restricted by donors in perpetuity; and deferred compensation assets related to certain deferred compensation agreements.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair market value in the balance sheets. Investment income or loss, including realized gains and losses on investments, interest, and dividends is included in nonoperating gains of unrestricted net assets, unless the income is restricted by donor or law. Changes in net unrealized gains and losses on investments are reported separately below the performance indicator and are included in unrestricted net assets, unless restricted by donor or law.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

Property and Equipment

Property and equipment are recorded at cost, except for donations, which are recorded at the fair market value at the date of the donation.

Property and equipment include expenditures for additions and repairs which substantially increase the useful lives of existing property and equipment. Maintenance, repairs, and minor improvements are expensed as incurred. The Hospital's policy is to capitalize all property and equipment items with a useful life of more than three years and a unit cost of \$1,000 or more.

The property and equipment of the Hospital are being depreciated using the straight-line method of depreciation over their estimated useful lives based upon the American Hospital Association's *Estimated Useful Lives of Depreciable Hospital Assets*.

Cost of Borrowing

Interest costs incurred on borrowed funds during the period of construction of capital assets, if any, are capitalized as a component of the cost of acquiring those assets.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Consolidated Statements of Activities

For purposes of display, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as revenues and expenses. Peripheral and incidental transactions are reported as gains and losses. Nonoperating gains which are excluded from income from operations, include contributions, investment income, investment fees, and donations made.

Charity Care

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are reported as deductions from revenue.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give, if any, are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted revenue if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of activities as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

Income Taxes

KDHHS is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

MCS is a limited liability company which is treated as a partnership for income tax purposes. As such, net taxable income or loss is taxed directly to the members and not to MCS. Accordingly, income taxes have not been reflected in the accompanying consolidated financial statements.

Risk Management

The Hospital is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The Hospital is insured for medical malpractice claims and judgments.

Reclassifications

Certain 2006 amounts have been reclassified to provide for consistency with reporting of 2007 information. These reclassifications have no effect on the previously reported total change in net assets or net assets.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

3. ASSETS WHOSE USE IS LIMITED

Assets whose use is limited that are required for obligations classified as current liabilities are reported in current assets. Assets whose use is limited are reported at market value and include the following at December 31, 2007 and 2006:

	2007	2006
Board-designated funds		
Cash and cash equivalents	\$ 4,732,951	\$ 3,107,503
U.S. Government securities	7,243,160	6,999,495
Preferred stocks	400,809	-0-
Common stocks	31,380,288	27,688,975
Equity mutual funds	1,913,432	4,125,668
Bond mutual funds	7,297,202	2,986,194
Corporate bonds	602,012	537,583
Total board-designated funds	53,569,854	45,445,418
Trustee-held funds		
Cash and cash equivalents	2,347,296	2,332,292
U.S. Government securities	-0-	673,383
Total trustee-held funds	2,347,296	3,005,675
Donor-restricted funds		
Cash and cash equivalents	105,321	41,964
Common stocks	-0-	10,000
Total donor-restricted funds	105,321	51,964
Deferred compensation funds		
Cash and cash equivalents	664,799	600,151
Equity mutual funds	258,288	204,649
Bond mutual funds	58,551	-0-
U.S. Government securities	243,911	255,800
Corporate bonds	2,994	-0-
Preferred stocks	2,827	-0-
Common stocks	64,493	63,701
Total deferred compensation funds	1,295,863	1,124,301
Total assets whose use is limited	57,318,334	49,627,358
Less amount required for current obligations	1,148,751	1,137,234
Assets whose use is limited, net of amount required to meet current obligations	<u>\$ 56,169,583</u>	<u>\$ 48,490,124</u>

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

Investment income is comprised of the following for the years ended December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Dividends and interest income	1,998,569	1,491,425
Realized gains on investments	1,992,814	1,145,820
Change in net unrealized gains and losses on investments	<u>304,958</u>	<u>1,529,908</u>
Total investment income	<u>\$ 4,296,341</u>	<u>\$ 4,167,153</u>

Board-Designated Funds

The Hospital's Board of Managers approved the funding of depreciation expense to meet the capital asset replacement needs of the facility. Depreciation is funded totally with expenditures for capital assets reducing the funded depreciation balance. All income earned by the Board-designated funds is left to accumulate as additions to the funds.

Trustee-Held Funds

The trustee-held funds are restricted for the payments of principal, interest, and construction costs related to certain long-term debt agreements.

Donor-Restricted Funds

Donor-restricted funds represent contributions that have been restricted by the donors for a specific purpose.

Deferred Compensation Funds

The deferred compensation funds represent assets that have accumulated under separate deferred compensation plans. The Hospital simply maintains the funds for the participants until they are withdrawn according to the specific terms of each separate deferred compensation agreement. The Hospital records liabilities equal to the deferred compensation assets.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

Unrealized Losses

The following schedule summarizes the fair value of securities included in assets whose use is limited that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of December 31, 2007 and 2006. The schedule further segregates the securities that have been in a gross unrealized position as of December 31, 2007 and 2006, for less than twelve months and those for twelve months or more. The analysis of securities as of December 31, 2007 and 2006, for impairment indicated that all impairment is considered temporary, market driven, and not credit-related. The majority of the decline is attributable to several stocks of financially strong companies by industry standards with which industry experts expect recovery in the short-term future. Because the decline in value is determined by management to be temporary, unrealized losses have not been reclassified to realized as of December 31, 2007 and 2006.

Description of Securities	2007					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	\$ 253,722	\$ 14,026	\$ 191,634	\$ 4,937	\$ 445,356	\$ 18,963
Bond mutual funds	-0-	-0-	3,626,319	43,681	3,626,319	43,681
Total debt securities	253,722	14,026	3,817,953	48,618	4,071,675	62,644
Equity mutual funds	638,538	14,096	1,802,685	32,315	2,441,223	46,411
Common stock	10,017,027	1,625,907	896,047	411,570	10,913,074	2,037,477
Total equity securities	10,655,565	1,640,003	2,698,732	443,885	13,354,297	2,083,888
Total temporarily impaired securities	\$ 10,909,287	\$ 1,654,029	\$ 6,516,685	\$ 492,503	\$ 17,425,972	\$ 2,146,532

Description of Securities	2006					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government securities	\$ 1,051,220	\$ 20,570	\$ 3,103,465	\$ 40,585	\$ 4,154,685	\$ 61,155
Corporate bonds	44,203	543	360,600	11,740	404,803	12,283
Bond mutual funds	-0-	-0-	2,986,194	33,806	2,986,194	33,806
Total debt securities	1,095,423	21,113	6,450,259	86,131	7,545,682	107,244
Equity mutual funds	-0-	-0-	2,966,170	66,499	2,966,170	66,499
Common stock	2,816,453	261,634	1,791,045	301,000	4,607,498	562,634
Total equity securities	2,816,453	261,634	4,757,215	367,499	7,573,668	629,133
Total temporarily impaired securities	\$ 3,911,876	\$ 282,747	\$ 11,207,474	\$ 453,630	\$ 15,119,350	\$ 736,377

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

4. OTHER ASSETS

Other assets consist of the following at December 31, 2007 and 2006:

	2007	2006
Bond issue costs	\$1,422,358	\$1,422,358
Bond issue costs, accumulated amortization	(497,824)	(450,412)
Goodwill of physician practices	8,060,000	8,060,000
Goodwill of physician practices, accumulated amortization	(5,631,277)	(5,093,949)
Investment in Captive insurance company	285,311	168,000
Notes receivable	<u>612,306</u>	<u>546,674</u>
 Total other assets	 4,250,874	 4,652,671
Less: current portion of other assets	<u>(180,512)</u>	<u>(159,657)</u>
 Other assets, net of current portion	 <u>\$4,070,362</u>	 <u>\$4,493,014</u>

Bond issue costs are being amortized over the 30-year life of the bonds beginning in 1997, using the straight-line method.

Goodwill relates to the purchase of physician practices and is being amortized over 15-year periods beginning in 1997 and 2000, using the straight-line method.

The Hospital is an 11 percent owner of Indiana Healthcare Reciprocal Risk Retention Group, a risk retention company created to purchase professional liability and general liability insurance for its members. The Hospital accounts for this investment using the cost method.

Physician notes receivable are in varying amounts maturing through July 2012. If the physicians meet the period of service requirement, the Hospital will forgive these notes. If the physicians do not meet the period-of-service requirement, the notes are immediately due in full. Interest rates vary from 5 percent to 9.25 percent.

The current portion of other assets represents the amount of notes receivable from physicians expected to be repaid or forgiven in the next fiscal year, according to individual employment contracts.

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

5. OBLIGATIONS UNDER CAPITAL LEASES

The Hospital is the lessee of certain equipment under capital leases expiring in various years through 2012. The assets and liabilities under capital leases are initially recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. Amortization of assets held under capital leases is included in depreciation expense and was \$72,207 and \$0 for the years ended December 31, 2007 and 2006, respectively.

Following is a summary of property held under capital leases:

	<u>2007</u>	<u>2006</u>
Equipment	\$1,419,169	\$ 15,000
Less: accumulated amortization	<u>72,207</u>	<u>-0-</u>
	<u>\$1,346,962</u>	<u>\$ 15,000</u>

Minimum future lease payments under capital leases as of December 31, 2007 are as follows:

<u>Year Ending December 31,</u>	<u>Amount</u>
2008	\$ 332,954
2009	332,638
2010	332,638
2011	332,564
2012	<u>274,039</u>
	1,604,833
Less: amount representing interest	<u>235,130</u>
Present value of minimum lease payments	<u>\$1,369,703</u>

THE KING'S DAUGHTERS' HOSPITAL AND HEALTH SERVICES AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2007 AND 2006

6. LONG-TERM DEBT

At December 31, 2007 and 2006, the Hospital was obligated for long-term debt agreements as follows:

	<u>2007</u>	<u>2006</u>
Indiana Health Facility Financing Authority Note, dated July 1997, payable in semi-annual principal installments commencing February 1998 through August 2027, in amounts ranging from \$205,000 to \$575,000. Remaining variable interest rates ranging from 5.10% to 5.625%. Secured by gross revenues.	\$13,815,000	\$15,275,000
Indiana Health Facility Financing Authority Promissory Note and Letter of Credit of up to \$2,000,000, dated November 2002 - paid off in 2007.	<u>-0-</u>	<u>197,899</u>
Total long-term debt	13,815,000	15,472,899
Less current portion	<u>860,000</u>	<u>1,017,899</u>
Long-term debt, net of current portion	<u>\$12,955,000</u>	<u>\$14,455,000</u>

Maturities of long-term debt for each of the five years subsequent to December 31, 2007, are as follows:

<u>Year Ending December 31,</u>	<u>Amount</u>
2008	\$ 860,000
2009	905,000
2010	955,000
2011	1,015,000
2012	1,075,000
Thereafter	<u>9,005,000</u>
Total	<u>\$13,815,000</u>

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Under the terms of the 1997 IHFFA notes payable, the Hospital is required to maintain certain deposits with a trustee. Such deposits are reported in the consolidated financial statements as assets whose use is limited. These agreements also place limits on the occurrence of additional borrowings and require that the Hospital satisfy certain measures of financial performance as long as the bonds and notes are outstanding.

7. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily restricted net assets are donor-restricted for a specific use or by the passage of time. Permanently restricted net assets are donor-restricted assets whereby the principal amount is never to be expended. Income earned from these principal amounts includes both temporarily restricted and unrestricted amounts. Temporarily and permanently restricted net assets include the following at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Temporarily restricted		
Prenatal/Postnatal Education Program Fund	\$ 2,468	\$ 2,731
Tobacco Settlement Fund	88,312	34,755
May Library Fund	<u>4,541</u>	<u>4,478</u>
Total temporarily restricted net assets	<u>\$ 95,321</u>	<u>\$ 41,964</u>
Permanently restricted		
Heberhart Endowment	<u>\$ 10,000</u>	<u>\$ 10,000</u>

8. NET PATIENT SERVICE REVENUE

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- **Medicare.** The Hospital is a provider of services to patients entitled to coverage under Title XVIII (Medicare) of the Health Insurance Act. The Hospital is reimbursed for Medicare inpatient services based on a fixed price per discharge for each diagnosis related grouping (DRG) and Medicare outpatient services based on a fixed price per clinical unit of service. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. At the Hospital's year end, a cost report is filed with the Medicare program computing reimbursement amounts related to Medicare patients. The difference between computed reimbursement and interim reimbursement is reflected as a receivable from or payable to the third-party program. The Hospital's classification of patients under

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the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization under contract with the Hospital. As of December 31, 2007, the Hospital's submitted Medicare cost reports have been final settled with the Fiscal Intermediary through December 31, 2005.

- **Medicaid.** The Hospital is a provider of services to patients entitled to coverage under Title XIX (Medicaid) of the Health Insurance Act. The Hospital is reimbursed for Medicaid inpatient services based on a fixed price per discharge for each diagnosis related grouping (DRG) and Medicaid outpatient services based on a fixed price per clinical unit of service. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. There is no cost settlement for either of the inpatient or outpatient programs.

The Hospital has also entered into preferred provider agreements with certain commercial insurance carriers. Payment arrangements to the Hospital under these agreements include discounted charges and fee schedule payments.

9. CHARITY CARE

The Hospital maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies provided under its charity care policy. The following information measures the level of charity care provided during the years ended December 31, 2007 and 2006.

	<u>2007</u>	<u>2006</u>
Charges forgone, based on established rates	<u>\$3,789,062</u>	<u>\$3,327,446</u>

10. PENSION PLAN

The Hospital sponsors a defined contribution pension plan that covers all eligible employees who work over 1,000 hours a year. Physicians are eligible for enrollment immediately after their hire date; all other employees must have completed one year of employment and be 21 years of age. The Hospital contributes 4 percent for each eligible employee. The employee may contribute up to 15 percent with a maximum of 6 percent being matched at a rate of 50 percent. For the years ended December 31, 2007 and 2006, the amount of pension expense was \$2,651,557 and \$2,522,300, respectively.

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11. DEFERRED COMPENSATION AGREEMENTS

Previously, the Hospital maintained an informal deferred compensation plan whereby amounts were withdrawn from participating physicians' pay and held by the Hospital until such time that the participating physicians retired. The Hospital no longer offers this plan, but still records a liability for any amounts which were unpaid at year-end. The deferred compensation asset and liability amounts under this agreement were both \$219,238 and \$235,873 at December 31, 2007 and 2006, respectively.

The Hospital funds executive insurance and deferred compensation benefit programs. The programs accumulate cash value over time. The Hospital records an asset and liability amount for the cash surrender value of the executive insurance program and an asset and liability amount equal to the market value of the deferred compensation program. The deferred compensation asset and liability amounts under this agreement were both \$968,041 and \$780,176 at December 31, 2007 and 2006, respectively.

Previously, the Hospital maintained a deferred compensation plan for a select group of key management employees. Under the terms of the plan, the Hospital contributed 4 percent of a participant's compensation, as defined in the agreement, each calendar quarter. The Hospital no longer offers this plan, but still records a liability for any amounts that were unpaid at year-end. The deferred compensation asset and liability amounts under this agreement were both \$108,584 and \$108,252 at December 31, 2007 and 2006, respectively.

12. PROFESSIONAL LIABILITY INSURANCE

The Indiana Medical Malpractice Act, IC 34-18, provides a maximum recovery of \$250,000 for an occurrence of malpractice and \$1,250,000 for an injury or death of a patient due to an act of malpractice. The Act requires physicians to maintain medical malpractice liability insurance in the minimum amount of \$250,000 per occurrence and \$750,000 in the annual aggregate and hospitals to maintain medical malpractice liability insurance in the minimum amount of \$250,000 per occurrence and \$7,500,000 for hospitals with more than 100 beds. The Act also requires the Hospital to pay a surcharge to the State Patient's Compensation Fund. This fund may be used to pay medical malpractice claims in excess of the annual aggregate amount noted above, under certain terms and conditions.

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The Hospital maintains professional liability insurance through a multiprovider reciprocal risk retention group, in which premiums are accrued based on the group's experience to date. This provides protection from liability in an amount not to exceed \$250,000 per incident and aggregate liability protection not to exceed \$10,000,000 per year. The Hospital's insurance policies conform to the Indiana Malpractice Act. In addition, the Hospital maintains two commercial umbrella/excess liability policies of \$10,000,000 each. Liabilities for incurred but not reported losses at December 31, 2007 and 2006 are not determinable; however, in management's opinion, such liabilities, if any, will not have a material effect on the Hospital's financial position and its malpractice and general liability insurance is adequate to cover losses, if any. Should the policies not be renewed or replaced with appropriate insurance coverage, claims based upon occurrences during these terms, but reported subsequently, will be uninsured. The Hospital intends to continue carrying such insurance.

13. CONCENTRATIONS OF CREDIT RISK

The Hospital grants credit without collateral to its patients, most of whom are local residents and insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31, 2007 and 2006, was as follows:

	<u>2007</u>		<u>2006</u>
Medicare	28	%	35
Medicaid	12		7
Blue Cross	9		10
Other third-party payors	21		23
Patients	<u>30</u>		<u>25</u>
	<u>100</u>	%	<u>100</u> %

The Hospital maintains its cash in bank deposit accounts, which at times, may exceed federally insured limits. The Hospital has not experienced any losses on such accounts. The Hospital believes it is not exposed to any significant credit risk on cash.

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14. FUNCTIONAL EXPENSES

The Hospital provides general healthcare services to residents within its geographic area. Expenses related to providing these services are broken down as follows for the years ended December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Healthcare services	\$ 94,176,592	\$88,694,638
General and administrative	<u>10,440,817</u>	<u>9,976,301</u>
	<u>\$104,617,409</u>	<u>\$98,670,939</u>

15. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by the Hospital in estimating the fair value of its financial instruments:

Cash and Cash Equivalents

The carrying amount reported in the consolidated balance sheets for cash and cash equivalents approximates its fair value.

Assets Whose Use is Limited

These assets are reported in the consolidated balance sheets at fair value. The fair value amounts are based on quoted market prices, if available, or are estimated using quoted market prices for similar securities.

Accounts Payable, Accrued Payroll and Payroll Withholdings, and Accrued Expenses

The carrying amounts reported in the consolidated balance sheets for accounts payable, accrued payroll and payroll withholdings, and accrued expenses approximate their fair value.

Estimated Third-Party Payor Settlements

The carrying amount reported in the consolidated balance sheets for estimated third-party payor settlements approximates its fair value.

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Long-Term Debt, Obligations Under Capital Leases and Deferred Compensation Liabilities

The carrying amounts reported in the consolidated balance sheets for long-term debt, obligations under capital leases and deferred compensation liabilities approximate their fair value.

16. IMPAIRMENT LOSS

During 2007, the Hospital recorded an impairment loss of \$456,608 on capital assets recorded in construction in progress. The impairment loss is included in Purchased Services on the Consolidated Statements of Activities. The assets were originally recorded in 2005 and 2006 and included costs associated with a proposed new Medical Office Building construction plan that has since been abandoned. Specific assets associated with the project that were considered impaired were architect fees and engineering fees that would have little or no value should the Hospital continue with a different facility construction plan.

17. CONTINGENCIES

There are a variety of legal proceedings and claims by others against the Hospital in a variety of matters arising out of the conduct of the Hospital's business. The ultimate resolution of such claims would not, in the opinion of management, have a material adverse effect on the consolidated financial statements.